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Consideration of elimination of the "subject to" qualification: public meeting - June 30, 1982 (part 2)

American Institute of Certified Public Accountants. Auditing Standards Board

Auditing Standards Board
American Institute of Certified Public Accountants

Consideration of Elimination of the "Subject To" Qualification

Public Meeting - June 30, 1982

Consideration of Elimination of the "Subject To" Qualification

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Consideration of Elimination of the "Subject to" Qualification

Introduction

The Auditing Standards Board (the Board) has agreed in principle to issue an exposure draft of a proposed Statement on Auditing Standards that would eliminate the qualified opinion ("subject to" qualification) for matters involving uncertainties. Because the issue affects users of audited financial statements, the Board is holding a special public meeting to discuss with such users their views as to the benefit of "subject to" qualifications. In particular, the Board would like to discuss the following questions with users:

> Is the "subject to" qualification useful as a "red flag" to draw users' attention to management's disclosures about significant matters involving uncertainties? What are the reasons for such a belief?

This paper discusses issues related to the "subject to" qualification and gives reasons why some auditors and users of auditors' reports wish to retain it and why others prefer to eliminate it. The following topics are discussed:

- Additional Guidance on Applying Existing Standards
- Changes in Reporting Practice
- Background Information
- Arguments For Retention and Elimination of the "Subject To" Qualification
    - The Qualification as a Red Flag
    - The Qualification and Fairness
    - The Qualification for Going Concern Uncertainties

- The Qualification and Communication
- Legal Considerations

- The Disclaimer and Emphasis of a Matter Paragraph

The appendix to this issues paper lists some research studies that have been conducted on the "subject to" qualification.

A copy of SAS No. 2, "Reports on Audited Financial Statements," which contains the existing reporting standards, and of the proposed SAS entitled "Matters Involving Uncertainties," are being furnished participants as an aid to discussion. The section of the proposed SAS on "Reporting Considerations" (paragraphs 10-11) sets forth the proposed new reporting standards for matters involving uncertainties. Because the proposed SAS provides that the auditor's opinion on financial statements should be unqualified when matters involving uncertainties are adequately accounted for and disclosed in conformity with generally accepted accounting principles, the first section of the proposed SAS gives auditors guidance on evaluating the adequacy of disclosure of such matters.

<u>Additional Guidance on Applying Existing Standards</u>

The proposed SAS provides guidance on the types of information an auditor should consider in evaluating the adequacy of disclosure of matters involving uncertainties in financial statements and procedures to obtain, corroborate and evaluate related information. A modification of the auditor's report currently is, and would continue to be, required for (1) a scope limitation if the auditor does not obtain sufficient evidential matter for a determination as to whether disclosure is adequate and (2) a departure from generally accepted accounting principles (GAAP) if he concludes that the matter has not been appropriately accounted for or disclosed.

Changes in Reporting Practice

The accompanying draft proposes significant changes to existing standards for reporting on matters involving uncertainties that are appropriately accounted for and disclosed in the financial statements. It proposes elimination of the modification of the auditor's report ("subject to" qualification and disclaimer of opinion) for existing matters involving future events, the occurrence or outcome of which is uncertain, including contingencies as defined by FASB Statement No. 5, "Accounting for Contingencies." Also, the proposed SAS states that the emphasis of a matter paragraph should not be used to draw attention to such matters.

Background Information

In 1975, the Financial Accounting Standards Board (FASB) issued Statement No. 5, "Accounting for Contingencies," which established standards for accruing and disclosing contingencies in financial statements. In 1977, the FASB issued Statement No. 16, "Prior Period Adjustments," which prohibited restatement of previously issued financial statements except in limited circumstances. Under Statement No. 16, resolutions of uncertainties such as income taxes and litigation, which previously were accounted for as prior period adjustments, are recorded in the financial statements of the period in which resolution occurs.

In February, 1977, the independent Commission on Auditors' Responsibilities (Cohen Commission) issued a recommendation that the "subject to" qualification should be eliminated for uncertainties, including uncertainties as to an entity's ability to continue in existence ("going concern uncertainties.") The Cohen Commission stated that deciding whether to give a "subject to" qualification requires the auditor to take on the inappropriate role of being a "reporter and interpreter of financial information" concerning uncertainties, whereas his proper role is to evaluate whether the information about uncertainties presented in financial statements conforms with appropriate standards. The Cohen Commission stated that in evaluating whether to qualify his opinion, the auditor has to consider the probability that the outcome will be resolved unfavorably and the amount of potential loss. Accounting standards preclude management from accruing for the uncertainty if it is unable to assess the outcome as probable and make a reasonable estimation of the potential loss, yet, as the Cohen Commission stated, existing reporting standards require the auditor to make an evaluation of probability independent of management's evaluation. The auditor frequently is in no better position than users of financial statements to predict the ultimate resolution of many uncertainties. The Cohen Commission also emphasized the need for full and clear financial statement disclosure about uncertainties as a basis for eliminating the subject to qualification.

Based primarily on the Cohen Commission's recommendation, in October, 1977, the Auditing Standards Executive Committee issued a proposed SAS that would have eliminated the "subject to" qualification for all types of uncertainties. The basis of elimination as stated in the exposure draft was that FASB Statement No. 5 constitutes generally accepted accounting principles for the accounting for and financial reporting of contingencies, and that presentation in conformity with GAAP comprehends the adequacy of informative disclosure in financial statements. Thus, that Committee concluded that when financial statement presentation and disclosure of uncertainties conforms with GAAP, the "subject to" qualification should not be given. However, the proposal was withdrawn partly because of concern that perhaps existing disclosure standards for uncertainties were inadequate or not properly applied in practice. Also, some auditors believed that the qualification should be retained for going concern uncertainties, arguing that since those types of uncertainty are pervasive to the entire financial statements and call into question the appropriateness of the basis of accounting used, only the auditor's report can adequately disclose their significance on the financial statements taken as a whole.

As to the adequacy of disclosure issue, communication with the FASB subsequent to 1977 resulted in no revisions to existing standards or active consideration of the adequacy of existing standards for disclosure of uncertainties. As to the going concern issue, early in 1981, the Auditing Standards Board issued SAS No. 34, "The Auditor's Considerations When A Question Arises About An Entity's Continued Existence," which includes guidance on consideration of the adequacy of financial statement disclosure of the conditions that raise a question about an entity's ability to continue in existence and the possible effects of those conditions on the financial statements.

In August, 1980, the Canadian Institute of Chartered Accountants (CICA) issued an auditing standard that eliminated the modification of the auditor's report ("subject to" qualification and the disclaimer of opinion) for all types of uncertainties presented in accordance with generally accepted accounting principles. That auditing standard also stated that a separate explanatory paragraph in the auditor's report should not be used to draw attention to the uncertainty.[1/]

The Board is aware of about a dozen research studies related to the potential usefulness of "subject to" qualifications. (See the Appendix for a list). The research can be categorized as studies of stock price performance of companies receiving a "subject to" qualification, surveys of attitudes, and experiments involving bankers, other lenders and students in simulated decision-making environments. The market price studies generally have found that there are significant stock price declines prior to the issuance of the auditor's qualified opinion with little or any reaction at the time the auditor's report is issued. The results of the surveys and experiments are mixed, however. Some of them conclude that the "subject to" qualification may be useful and others conclude that it is not.

[1/] The CICA's action caused a reporting conflict in situations where financial statements of a Canadian company are audited and reported on in accordance with Canadian generally accepted auditing standards and filed with the U.S. Securities and Exchange Commission, and contain a contingency which would cause a modification of the auditor's report under U.S. generally accepted auditing standards. In such circumstances, a paragraph is added below the auditor's report, making reference to the note in the financial statements that describes the uncertainty, and indicating that under U.S. generally accepted auditing standards such an uncertainty would cause modification of the auditor's report.

In developing the accompanying proposed SAS, the Auditing Standards Board considered the developments summarized above as well as the arguments for retention and elimination of the requirement for modification of the auditor's report for matters involving uncertainties that are discussed below.

Arguments For Retention and Elimination of the "Subject To" Qualification

The Qualification as a Red Flag

Some auditors and users of audited financial statements argue that the "subject to" qualification is a useful "red flag" that draws the user's attention to the existence of a matter that could have a significant effect on the entity's financial status. They believe that financial statement disclosures have become so numerous, lengthy and complex that the "subject to" qualification is needed as an indicator of the existence of a material uncertainty and as a signal that the auditor believes it's ultimate resolution could have a potentially significant effect on the entity's financial position and results of operations.

Those persons who want to eliminate the qualification are not convinced that the red flag is useful and they believe that it may be misleading to users. Specifically, they believe users may misinterpret a "subject to" qualification as indicating that something is wrong with the financial statements being reported on, that the auditor disagrees with management's financial statement treatment of the uncertainty, or that those financial statements will be adjusted when the matter is resolved. However, if the auditor believes the financial statements do not properly account for and disclose the uncertainty in conformity with generally accepted accounting principles, a qualified or an adverse opinion for a departure from GAAP would be called for and a modification solely because of the uncertainty would not be appropriate. In addition, except in rare circumstances, when the uncertainty is subsequently resolved any necessary adjustment will be reflected in that period's financial statements and prior years' statements will not be adjusted. Thus, proponents of elimination believe that the "subject to" qualification is misleading because the financial statements are in conformity with GAAP with respect to the uncertainty, and since there is nothing more that can or should be done to the financial statements to make them conform to GAAP, it is misleading not to give an unqualified opinion.

While the "subject to" qualification draws users' attention to a particular uncertainty, it may at the same time draw their attention away from other uncertainties disclosed in the financial statements for which the auditor has not qualified his opinion. The decision to give a "subject to" opinion is necessarily subjective, and other equally significant matters may be overshadowed by the uncertainty that is highlighted by the qualification. Also, the existence of the opportunity for a qualification may cause some users erroneously to assume that when there is no qualification there are no uncertainties or business risks facing the entity about which they should be concerned.

The Qualification and Fairness

Some auditors who favor retention of the "subject to" qualification believe that they should not be required to express an unqualified opinion on the statements prepared in conformity with generally accepted accounting principles when material uncertainties exist. They believe that the auditor has a responsibility to evaluate the overall fairness of financial statements apart from the application of generally accepted accounting principles, and they hold that he should be allowed to express separately his concern that there is at least a reasonable possibility that the ultimate resolution of the uncertainty will adversely affect financial position and results of operations.

Other auditors point out, however, that management, not the auditor, has the responsibility for financial statements that adequately disclose the uncertainty, including, if necessary, disclosure that the ultimate resolution of the uncertainty could have a serious negative effect on financial position and results of operations. The auditor's responsibility is to assess whether the financial statements adequately disclose the uncertainties that the entity faces. In making that evaluation, the auditor is guided by generally accepted accounting principles. GAAP encompasses fairness; SAS No. 5, "The Meaning of 'Present Fairly in Conformity with Generally Accepted Accounting Principles' in the Independent Auditor's Report," states that "the independent auditor's judgment concerning the 'fairness' of the overall presentation of financial statements should be applied within the framework of generally accepted accounting principles." The SAS also states that in evaluating conformity with GAAP, the auditor makes a judgment as to whether the financial statements, "including the related notes, are informative of matters that may affect their use, understanding, and interpretation." Once the auditor has made the evaluation as to the adequacy of financial statement disclosure of the uncertainty, as the Cohen Commission stated, it is inappropriate for the auditor to act as a "reporter and interpreter" of that information.

The Qualification for Going Concern Uncertainties

Some auditors believe that uncertainties as to an entity's ability to continue in existence are significantly different than other uncertainties and therefore, the modification of the auditor's report should be retained for such situations. They maintain that the going concern assumption is so fundamental to the application of generally accepted accounting principles that if the going concern assumption is doubtful, the auditor should modify his report to convey his overriding concern as to the appropriateness of the basis of accounting on which the financial statements are prepared. Other auditors believe that in some instances the financial statements may adequately disclose several significant uncertainties but that only the modification of the auditor's report can interrelate the several individual uncertainties, that if unfavorably resolved could make the continued existence of the entity doubtful.

Those persons who oppose retaining the modification of the auditor's report for going concern uncertainties see no justification for making a distinction since the consideration runs to the recoverability and classification of recorded assets and the amounts and classification of liabilities. On practical grounds, they point to the difficulty of distinguishing between uncertainties which do and do not affect the going concern assumption. Thus, they believe that such a standard that would require or allow modification of the auditor's report only for going concern uncertainties would be impractical to implement and inconsistently applied in practice. In addition, such a focus on the modification of the auditor's report distracts from the fact that the financial statements, including the notes, can, and should, adequately portray the situation, including as appropriate, the relationship between various uncertainties, their implications for the entity's ability to continue in existence and the possible effects should it fail to do so. They note that SAS No. 34 directs the auditor to consider the need for, and adequacy of, those types of disclosures in the financial statements and they believe that the auditor's report is not the proper vehicle for such disclosures.[2/]

The Qualification and Communication

Some auditors believe that the "subject to" qualification has certain "behavioral" features that enhance communications among lawyers, managements and auditors about uncertainties. They believe that when an uncertainty involving litigation or another legal matter exists, consideration of the possibility of a "subject to" qualification motivates lawyers to provide management with a more definitive legal opinion as to the potential outcome as a precondition to an unqualified opinion, so that management is better equipped to prepare, and the auditor to evaluate, appropriate and informative financial statement presentation and disclosure of the matter. They are concerned that elimination of the "subject to" qualification may result in less

[2/] Appendix A to the accompanying proposed SAS also gives guidance relating to disclosures of going concern problems.

attention being paid by those parties to the evaluation of the uncertainty.

Also, some auditors believe that the possibility of a "subject to" qualification for an uncertainty focuses more attention by management and the auditor on the adequacy of financial statement disclosure as a precondition to an unqualified opinion. However, proponents of elimination believe that the motivation for adequate disclosure should be based on the possibility of an "except for" qualification because of a GAAP departure if disclosure is inadequate. Since a qualification because of a GAAP departure is more severe than a "subject to" qualification, that motivation should not be lost by elimination of the "subject to" qualification. Proponents of elimination believe that it is desirable to remove the possibility of inappropriately using the "subject to" qualification to mask a disclosure inadequacy in the financial statements.

Legal Considerations

Legal protection is sometimes cited as a reason for retaining the "subject to" qualification. Some auditors believe that if an entity's reported financial position and results of operations are challenged in litigation and the auditor's work or report is questioned, he is in a better legal position if the report contained a modification putting users on notice as to the auditor's uncertainty about some aspect of the financial statements. Certainly, they argue, such a modification can do the auditor no legal harm. However, recent cases indicate that the "subject to" opinion does not insulate the auditor from legal liability if the financial statements and related notes do not contain adequate disclosure. Thus, the "subject to" qualification may be of dubious legal value, and to the extent that it might diminish the auditor's concern over the need for adequate financial statement disclosure, it may constitute a legal hazard.

The Disclaimer and Emphasis of a Matter Paragraph

The Auditing Standards Board, in proposing to change reporting standards for uncertainties, has concluded that if it is appropriate to eliminate the "subject to" qualification, it would be inconsistent to allow other forms of report modification for such uncertainties. Therefore, the proposed SAS eliminates the disclaimer of opinion and the emphasis of a matter paragraph for an uncertainty for which an opinion currently could be qualified or disclaimed.

Some auditors contend that they should not be forced to express an opinion if they do not have one and that they should be allowed to make explanations within their report. In contrast, some proponents of elimination believe that when financial statements properly account for and disclose uncertainties in conformity with GAAP, the auditor should express an opinion to that effect. They also believe that when financial statement disclosures about uncertainties are in conformity with generally accepted accounting principles, information contained in an explanatory paragraph in the auditor's report (whether the opinion is unqualified, qualified or a disclaimer) is redundant with information in the financial statements. Furthermore, they believe that the benefits of eliminating the "subject to" qualification for uncertainties will be diminished if the disclaimer or emphasis of a matter paragraph is retained for such uncertainties.

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The Auditing Standards Board believes that eliminating the "subject to" qualification could result in improved reporting practices by removing any confusion that might exist as to whether the "subject to" qualification can be used in lieu of the more onerous "except for" qualification because of inappropriate accounting treatment or inadequate disclosure of matters involving uncertainties. It also believes that when the possibility for a report modification for uncertainties is eliminated, auditors will place greater emphasis on the quality of informative disclosures about uncertainties. Therefore, the Board has developed the accompanying proposed SAS to provide guidance on obtaining and corroborating information about matters involving uncertainties and evaluating its presentation in financial statements.

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Research Studies on the "Subject To" Qualification

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"Lending officers' Attitudes Toward 'Subject To' Audit Opinions," The Journal of Commercial Bank Lending, March, 1978.

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PROPOSED STATEMENT ON AUDITING STANDARDS

Matters Involving Uncertainties

(Supersedes Statement on Auditing Standards No. 2, "Reports on Audited Financial Statements," paragraphs 9f, 21-26, 29c and 39, and Statement on Auditing Standards No. 34, "The Auditor's Considerations When A Question Arises Concerning An Entity's Ability to Continue in Existence," paragraphs 11-13)[1]

1. This Statement provides guidance on the auditor's considerations in evaluating the adequacy of disclosure in financial statements of information on existing matters involving future events, the occurrence or outcome of which is uncertain, that should be disclosed in conformity with generally accepted accounting principles. Such matters include, but are not limited to, contingencies covered by FASB Statement No. 5, "Accounting for Contingencies."[2] This Statement also provides guidance on the procedures the auditor may apply to identify the existence of such matters and obtain, corroborate and evaluate information concerning them, and it provides guidance on the appropriate form of reporting when conditions involving uncertainties exist.

2. FASB Statement No. 5, paragraph 1, defines a contingency for its purpose as "an existing condition, situation, or set of circumstances involving uncertainty as to possible...loss...to an enterprise that

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[1] This Statement also amends the Statements on Auditing Standards listed in Appendix A to this Statement.

[2] In addition to FASB Statement No. 5, other authoritative accounting literature contains detailed disclosure standards related to specific matters involving uncertain future events. For example, FASB Statement No. 47 gives standards for "Disclosure of Long-Term Obligations."

will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm... the loss or impairment of an asset or the incurrence of a liability.[3] That FASB Statement prescribes criteria for determining whether a contingency should be accounted for, disclosed in notes to the financial statements, or neither accrued or disclosed.

3. Regarding disclosure of a contingency, FASB Statement No. 5, paragraph 9, states, "Disclosure of the nature of an accrual... and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading." If an accrual is not made because the criteria for accrual are not met, paragraph 10 of that Statement requires, in certain circumstances, disclosure of the nature of the contingency, an estimate of the possible loss or range of loss or a statement that such an estimate cannot be made.

4. The third standard of reporting states that, "Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report." SAS No. 5, "The Meaning of 'Present Fairly in Conformity with Generally Accepted Accounting Principles' in the Independent Auditor's Report," paragraph 4, states that the auditor's judgment as to fair presentation

[3] FASB Statement No. 5 also defines a gain contingency, and paragraph 17 of that Statement prescribes the accounting and disclosure treatment for gain contingencies. The auditor's concern as to adequacy of disclosure of contingencies and other matters involving uncertainty is not limited to ones involving potential loss.

in conformity with generally accepted accounting principles includes a judgment as to whether "the financial statements, including the related notes, are informative of matters that may affect their use, understanding and interpretation." Statement on Auditing Standards No. 32, "Adequacy of Disclosure in Financial Statements," paragraph 2, states, "The presentation of financial statements in conformity with generally accepted accounting principles includes adequate disclosure of material matters. These matters relate to the form, arrangement and content of the financial statements and their appended notes, including, for example...the amount of detail given....An independent auditor considers whether a particular matter should be disclosed in light of the circumstances and facts of which he is aware at the time."

5. Other Statements on Auditing Standards give more specific guidance on the auditor's considerations regarding the adequacy of disclosure in particular circumstances involving uncertainties. For example, SAS No. 34, "The Auditor's Considerations When A Question Arises About An Entity's Continued Existence," paragraph 10, states that "The auditor should consider the need for, and the adequacy of, disclosure of the principal conditions that raise a question about an entity's ability to continue in existence, the possible effects of such conditions, and management's evaluation of the significance of those conditions and any mitigating factors." The paragraph also gives guidance concerning disclosure of plans of management in certain circumstances. Other parts of the SAS list types of information the auditor should consider in dealing with a question that has arisen about an entity's ability to continue in existence.

Nature and Related Amounts of Matters Involving Uncertainties

6. According to FASB Statement No. 5, when financial statements include an accrual for a contingency and in certain circumstances when an accrual is not made, the financial statements should disclose the nature of the contingency. Also, FASB Statement No. 5 provides that in some circumstances disclosure of the amount of an accrual for a contingency may be necessary. The Statement requires, in certain circumstances when an accrual is not made, disclosure of an estimate of the possible loss or range of loss or a statement that an estimate cannot be made.[4/] Thus, to satisfy himself as to the adequacy of disclosure with respect to an existing matter involving future events, the occurrence or outcome of which is uncertain, the auditor should obtain an understanding of the nature of the situation and of the amounts involved.

7. In developing an understanding of the nature of the situation, information such as the following should be considered:

a. Identification of the existing condition, situation or set

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[4/] In preparing financial statements, management estimates the outcome of future events. For example, estimates customarily are made about the useful lives of depreciable assets, the collectibility of accounts receivable, the realizable value of inventory items, and the amount of a liability for product warranty. Usually, the auditor is able to satisfy himself regarding the reasonableness of management's estimates by considering various types of evidential matter, including the historical experience of the entity, and the relevance of the evidence in estimating the effects of future events. Evidence as to the resolution of a matter involving an uncertainty (as opposed to evidence as to the nature of the situation) cannot be expected to exist at the time of the auditor's examination because the resolution, and therefore the evidence, is prospective. The auditor's function in forming an opinion on financial statements does not include estimating the outcome of future events if management is not able, or not required by generally accepted accounting principles, to do so.

of circumstances that indicate a contingency or uncertainty exists, for example -

- An asserted claim or alleged cause of action underlying a lawsuit, with identification of the type of claim or action, such as a claim for taxes, alleged patent infringement or alleged violation of anti-trust laws or other government regulations.

- Conditions that create an uncertainty about an entity's ability to continue in existence, such as contrary factors and underlying conditions, as discussed in SAS No. 34.

- An obligation that creates a contingency, for example, a guarantee of another's debt.

b. Identity of the parties or entities involved in the situation, for example, identity of -

- The plaintiff or defendant in a lawsuit, such as whether it is a class of consumers, several companies in a particular industry, certain corporate officials, certain subsidiaries, another business entity, or a government regulatory agency.

- The party to whom the entity is contingently liable, such as the IRS, or banks holding guaranteed debt or receivables sold with recourse.

c. Information as to when the condition or situation creating the contingency or uncertainty occurred, for example -

- The dates of significant developments in litigation and the period when the alleged cause of action took place.

- The tax years that are being questioned by the IRS.

- The term of a long term obligation.

- Periods involved in management plans or projections, as discussed in SAS No. 34.

d. Identification of the asset that may be impaired or the liability that may be incurred, for example -

- Whether the uncertainty relates to a specific asset or a class of assets, or whether the uncertainty is pervasive to most items in the financial statements.

- Liability for payment of additional taxes, interest, a fine or damages, or for costs to comply with a government regulation.

e. Identification of the future events that will resolve the uncertainty, including, if known, when resolution is likely to occur. Such future events include:

- A final decision by a court of law or a government agency.

- Success or failure in disposing of an asset, marketing a product or obtaining financing.

- Maturity of debt that is being guaranteed.

f. Determination of the current status of the situation, for example information on:

- The stage of progress of a lawsuit or a tax audit.

- Management's progress in negotiating a debt restructure or sale of certain assets.

- Management's or legal counsel's assessment of the probability of a favorable or unfavorable outcome of the situation.

8. In developing an understanding of amounts related to situations involving uncertainties, information such as the following should be considered.

a. When the financial statements include an accrual:

- The amount accrued.

- The basis or method of estimating the accrual, including significant assumptions used, and if the estimate is based on the entity's or other entities' experience, whether that experience is relevant.

- Classification of the accrual in the financial statements, including the current and noncurrent portion, and terminology used in the financial statements to describe the item.

- Whether the potential loss may exceed the amount accrued.

b. If an accrual has not been made, the auditor considers the reason, for instance, whether a reasonable estimate could not be made of the amount of potential loss or whether the probability of loss did not meet the criteria for accrual in FASB Statement No. 5. The auditor also considers whether a statement is required in the financial statements to the effect that a reasonable estimate could not be made.[5/] Examples of other information the auditor should consider include:

- The estimated amount or range of a potential loss.

- The recorded amount of the assets at risk.

- The amount of damages claimed, tax assessments made, debt that is guaranteed.

- The amount of possible recoveries on guaranteed debt or receivables sold with recourse or possible salvage value or proceeds that could be realized on the disposal of assets.

[5/] FASB Statement No. 5, paragraphs 23 and 25 discusses situations where the inability to make a reasonable estimate may raise questions as to the appropriateness of the accounting principles used. In forming an opinion as to whether financial statements are in conformity with generally accepted accounting principles, among other things, the auditor evaluates whether accounting principles used are appropriate in the circumstances.

Auditing Procedures

9. The auditor applies auditing procedures directed at contingencies or other matters involving uncertainty in order to obtain or corroborate the types of information described in paragraphs 7-8. Examples of procedures are given below.[6]

a. Discussions with appropriate management personnel, including those having responsibility for administration, finance, operations and accounting activities pertinent to the situation.

b. Obtaining knowledge of, and considering, the nature of the entity's business and operating characteristics, the industry in which it operates, general economic conditions and government regulations that bear on the situation.

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[6] The following Statements on Auditing Standards also describe other procedures:

- SAS No. 12, "Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments," paragraphs 5-10, describes auditing procedures for obtaining evidential matter relevant to the events or conditions related to litigation, claims and assessments.

- SAS No. 19, "Client Representations," paragraph 4, describes written representations that the auditor obtains from management regarding, among other things, plans or intentions that may affect the carrying value or classification of assets or liabilities, other liabilities and gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5, and unasserted claims or assessments.

- SAS No. 34, "The Auditor's Considerations When A Question Arises About An Entity's Continued Existence," paragraph 10, states that the auditor makes any substantive tests he considers necessary and practicable to assess contrary information, mitigating factors and management plans. Paragraphs 7-9 describe considerations and procedures that are applicable to the information, factors and plans, and state that the considerations are based on knowledge of the entity, its business and its management, and of conditions underlying the contrary information.

c. Review of correspondence that might give information about the background, current status, future prospects or amount of potential loss, such as -

- Contracts or agreements between the entity and other parties involved in the situation.

- Tax examiner's report or a notice of assessment.

- Correspondence between the entity and its legal counsel.

- Minutes of meetings of the Board of Directors describing the situation or containing resolutions of the Board concerning intended actions for dealing with the situation.

d. Review of accounting records or financial statements relating to assets that may be impaired or liabilities that may be incurred.

e. Confirmation with outside parties, such as confirmation of -

- Details with the other party to an agreement that creates an unconditional purchase obligation that includes variable components, as described in FASB Statement No. 47.

- Details as to methods and assumptions about loss estimates from specialists.

Reporting Considerations

10. If, based on his professional judgment, the auditor is satisfied that he has obtained sufficient evidential matter concerning the contingency or other situation involving uncertainty, and if he is satisfied that the financial statements adequately account for and disclose the situation in conformity with generally accepted accounting principles, he should express an unqualified opinion with regard to the situation. In such circumstances it is not appropriate to qualify the opinion or to disclaim an opinion solely because of the uncertainty, since the auditor has concluded that, with respect to the situation, the financial statements are in conformity with generally accepted accounting principles. Also, it is not appropriate to use an emphasis of a matter paragraph in the report to draw attention to the situation.

11. If the auditor does not obtain sufficient evidential matter, he should express a qualified opinion or disclaim an opinion because of a scope limitation.[7/] If the auditor concludes that the situation is not adequately disclosed in the financial statements, he should qualify his opinion or express an adverse opinion because of a departure from generally accepted accounting principles.[8/]

[7/] See SAS No. 2, "Reports on Audited Financial Statements," paragraphs 10-11, "Scope Limitation."

[8/] See SAS No. 2, "Reports on Audited Financial Statements," paragraph 17, "Inadequate Disclosure." Also, if the auditor, on the basis of evidence available to him, disagrees with management's estimate of the amount of potential loss, and if the effects on the financial statements are material, he should express a qualified or an adverse opinion because of a departure from generally accepted accounting principles. See SAS No. 2, paragraphs 15-16.

Effective Date and Transition

12. This statement is effective for reports dated on or after ____________________________.

13. When reporting on the current period's financial statements or updating a report on the prior period's statements in a report on comparative financial statements, a qualified opinion or a disclaimer of opinion because of a matter involving an uncertainty is not appropriate even if the prior period report contained such a qualified opinion or disclaimer of opinion and the circumstances remain essentially unchanged from the prior period.

14. SAS No. 15, "Reports on Comparative Financial Statements," paragraph 7, states that if an auditor expresses an opinion (or disclaims an opinion) in an updated report different from his previous opinion (or disclaimer of opinion) on the financial statements of a prior period, he should disclose all the substantive reasons for the different opinion in a separate explanatory paragraph of his report. Thus, for updated reports on comparative financial statements dated in accordance with the effective date specified in paragraph 12, where the prior period's report contained a qualified opinion or a disclaimer of opinion because of a matter involving an uncertainty and the matter still exists, the report should contain an explanatory paragraph similar to the following:

> In our report dated March 15, 19X2, our opinion on the 19X1 financial statements was qualified as being subject to the effects on the 19X1 financial statements of such

> adjustments, if any, as might have been required had the outcome of certain litigation been known. The litigation is continuing and is described in Note X.[9/] A qualification of opinion because of such matters is no longer provided for under generally accepted auditing standards. Accordingly, our present opinion on the 19X1 financial statements, as presented in this report, is different from that expressed in our previous report.

15. SAS No. 15, paragraph 12, states that when comparative financial statements are presented and a predecessor auditor's opinion on the prior period's financial statements was other than unqualified and the predecessor auditor's report is not presented, the successor auditor should describe the nature of and reasons for the qualification. Thus, the scope paragraph and explanatory paragraph of a successor auditor's report dated in accordance with the effective date specified in paragraph 12 would contain a statement such as the following if the uncertainty still exists:

> We have examined the balance sheet of ABC Company as of December 31, 19X2, and the related statements of....The

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[9/] If the matter has been resolved during the current period, the explanatory paragraph should indicate that fact, for example, by stating "as explained in Note X, the litigation was settled as of November 1, 19X2, at no material cost to the Company. Also, a qualification of opinion because of such matters is no longer..."

financial statements of ABC Company for the year ended December 31, 19X1, were examined by other auditors whose opinion, dated March 1, 19X2, on those statements was qualified as being subject to the effects on the 19X1 financial statements of such adjustments, if any, as might have been required had the outcome of the litigation discussed in Note X to the financial statements been known.

The litigation referred to in the preceding paragraph is still continuing.[10/] A qualification of opinion because of such matters is no longer provided for under generally accepted auditing standards. Accordingly, our opinion on the 19X2 financial statements does not contain a qualification of opinion because of the matter.

[10/] If the uncertainty has been resolved in the current period, the explanatory paragraph would contain a statement such as "The litigation referred to in the previous paragraph was settled as of November 1, 19X2 at no material cost to the Company. Also, a qualification of opinion because of such matters is no longer..."

Statements on Auditing Standards Superseded or Amended by this Statement

The following Statements on Auditing Standards are amended:

- SAS No. 1, section 545, "Inadequate Disclosure," paragraph 3, and SAS No. 2, "Reports on Audited Financial Statements," paragraph 27, to add the following sentence to the end of those paragraphs:

  It is not appropriate to draw attention in the auditor's report to matters concerning contingencies or other situations involving uncertainty as discussed in SAS No. ______, "Matters Involving Uncertainties" paragraph 10, when the auditor expresses an unqualified opinion with respect to the matter or situation.

- SAS No. 2, "Reports on Audited Financial Statements," paragraph 29, to delete the words "subject to" from the first sentence, and paragraph 45, to remove the first two sentences of footnote 10.

- SAS No. 12, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," paragraph 14, to replace the last two sentences with the following:

  In such circumstances, the auditor considers the adequacy of disclosure of the situation in the financial statements in light of the circumstances and facts of which he is aware at the time. SAS No. _____, "Matters Involving Uncertainties," paragraphs 6-8, gives guidance on information the auditor considers in reaching a determination as to whether he has obtained sufficient competent evidential matter to decide whether disclosure is adequate.

- SAS No. 15, "Reports on Comparative Financial Statements," paragraph 6, to delete the first two items; paragraph 7, to delete the first three examples; and paragraph 5, to change the first example to the following:

Qualified Opinion on Current Year's Financial
Statements with Prior Year Unqualified

(Explanatory paragraph)

The Company has charged to expense in the accompanying 19X2 income statement interest expense of $ ________ that was incurred in 19X2 related to expenditures during the period for the construction of a manufacturing facility. In our opinion, generally accepted accounting principles require that such interest cost should be capitalized. If those costs were capitalized, property would be increased by $ ________ and retained earnings by $ ________ as of December 31, 19X2, and net income and earnings per share would be increased by $ ________ and $ ________ respectively for the year then ended.

(Opinion paragraph)

In our opinion, except for the effects on the 19X2 financial statements of not capitalizing interest costs, as discussed in the previous paragraph, the accompanying financial statements present fairly the financial position of ABC Company as of December 31, 19X2 and 19X1, and the results of its operations and changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Also, the second example of paragraph 5 of SAS No. 15 is changed to the following:

Qualified Opinion on Prior Year's Financial Statements with the Current Year Qualified for the Same Reason and an Additional Reason

(Explanatory paragraphs)

As discussed more fully in Note X, the Company has excluded from property and debt in the accompanying 19X1 and 19X2 balance sheets certain lease obligations that were entered into in 19X1, which, in our opinion, should be capitalized in order to conform with generally accepted accounting principles.

As shown in the accompanying 19X2 financial statements, during 19X2 the Company issued certain preferred stock in the amount of $__________. The notes to the financial statements, however, do not disclose that the Company is obligated to make annual cumulative sinking fund payments of $__________ until the stock is retired.

(Opinion Paragraph)

In our opinion, except for the effects on the 19X1 and 19X2 financial statements of not capitalizing certain lease obligations, as described in the second paragraph, and except for the omission from the 19X2 financial statements of the information in the preceding paragraph, the accompanying financial statements present fairly the financial position of ABC Company as of December 31, 19X2 and 19X1, and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

In addition, the second example of SAS No. 15, paragraph 12, is changed to the following:

...were examined by other auditors whose opinion, dated March 1, 19X2, on those statements was qualified because of a limitation on the scope of their examination due to their inability to observe the physical inventories at January 1, 19X1.

- SAS No. 17, "Illegal Acts By Clients," to delete paragraph 16.
- SAS No. 34, "The Auditor's Considerations When A Question Arises About An Entity's Continued Existence," to add the following paragraph after paragraph 9:

<u>Considerations if Ability to Continue in Existence is Doubtful</u>

If after (a) considering the significance of the contrary information and any mitigating factors, (b) discussing plans, prospective data, and other appropriate matters with management, and (c) making any substantive tests that the auditor considers necessary and practicable to assess such information, factors and plans, the auditor concludes that a substantive doubt remains about the entity's ability to continue in existence, he should consider the recoverability and classification of recorded asset amounts, and the amounts and classification of liabilities in light of that doubt. If there is impairment in the value of an asset, the auditor should consider whether the financial statements require modification to be in accordance with generally accepted accounting principles. In such a case, if the financial statements are not revised, the auditor should modify his report because of a departure from generally accepted accounting principles. Also, consideration of the conditions that cause the auditor to have a substantial doubt about an entity's ability to continue in existence and of the recoverability of assets and amounts of liabilities in light of that doubt may cause the auditor to conclude that there exist loss contingencies which should be accounted for or disclosed in accordance with FASB Statement No. 5, "Accounting for Contingencies." See SAS No. ___, "Matters Involving Uncertainties," including paragraphs 10-11, "Reporting Considerations."

- SAS No. 34 to add the following paragraph to the end of paragraph 10:

Reference might be made to relevant amounts shown in the financial statements, such as the amount of net loss, working capital deficiency or excess of total liabilities over total assets, or amounts and classifications of assets and liabilities to which adjustments might be necessary should the entity be unable to continue in existence.

- SAS No. 36, "Review of Interim Financial Information, paragraph 20, to delete the reference to "an uncertainty" in the third sentence.

- SAS No. 38, "Letters for Underwriters," to delete paragraphs 31 and 53, and to delete the last sentence of paragraph 33.

Also, this Statement withdraws the following auditing interpretations:

- AU 9509.11-.14, "Reporting on Loss Contingencies."
- AU 9509.25-.28, "The Materiality of Uncertainties."
- AU 9509.29-.32, "Reporting on an Uncertainty."

AU Section 509

Reports on Audited Financial Statements

(Supersedes sections 510.01-515.10, 535.01-542.04, 544.01 and 547.01-547.04)

Effective for reports issued on financial statements for periods ending on or after December 31, 1974, unless otherwise indicated [1]

Introduction

.01 This section applies to auditors' reports issued in connection with examinations of financial statements that are intended to present financial position, results of operations or changes in financial position in conformity with generally accepted accounting principles. It distinguishes the types of reports, describes the circumstances in which each is appropriate, and provides examples.

.02 This section does not apply to unaudited financial statements that an accountant has been engaged to prepare or assist in preparing (see section 504 *), nor does it apply to reports on incomplete or capsule financial information or on other special presentations (see section 621 **).

.03 Justification for the expression of the auditor's opinion rests on the conformity of his examination with generally accepted auditing standards and on his findings. Generally accepted auditing standards include four standards of reporting. (See section 150.02.)

This section is concerned primarily with the relationship of the fourth reporting standard to the language of the auditor's report.

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[1] See paragraph .50.

[2] [Deleted.]

* Reference changed by issuance of Statement on Auditing Standards No. 26.

** Reference changed by issuance of Statement on Auditing Standards No. 14.

.04 **The fourth standard of reporting is as follows:**

> The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

.05 The objective of the fourth standard is to prevent misinterpretation of the degree of responsibility the auditor is assuming when his name is associated with financial statements. Reference in the fourth reporting standard to the financial statements "taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement, for example, to a balance sheet. The auditor may express an unqualified opinion on one of the financial statements and express a qualified or adverse opinion or disclaim an opinion on another if the circumstances call for this treatment.

Auditor's Standard Report

.06 The auditor's report customarily is used in connection with the basic financial statements — balance sheet, statement of income, statement of retained earnings and statement of changes in financial position. If these financial statements are accompanied by a separate statement of changes in stockholders' equity accounts, it should be identified in the scope paragraph of the report but need not be reported on separately in the opinion paragraph since such changes are included in the presentation of results of operations and changes in financial position.

.07 The auditor's standard report consists of a statement describing the nature of the examination, usually in an opening or "scope" paragraph, and an expression of the auditor's opinion, usually in a closing or "opinion" paragraph. The form of the standard report is as follows:

(Scope paragraph)

> We have examined the balance sheet of X Company as of [at] December 31, 19XX, and the related statements of income, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the ac-

counting records and such other auditing procedures as we considered necessary in the circumstances.

(Opinion paragraph)

In our opinion, the financial statements referred to above present fairly the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

.08 The report may be addressed to the company whose financial statements are being examined or to its board of directors or stockholders. A report on the financial statements of an unincorporated entity should be addressed as circumstances dictate, for example, to the partners, to the general partner, or to the proprietor. Occasionally, an auditor is retained to examine the financial statements of a company that is not his client; in such a case, the report customarily is addressed to the client and not to the directors or stockholders of the company whose financial statements are being examined.

Circumstances Resulting in Departure From Auditor's Standard Report

.09 The circumstances that result in a departure from the auditor's standard report[3] are as follows:

a. The scope of the auditor's examination is affected by conditions that preclude the application of one or more auditing procedures he considers necessary in the circumstances.
b. The auditor's opinion is based in part on the report of another auditor.
c. The financial statements are affected by a departure from a generally accepted accounting principle.
d. The financial statements are affected by a departure from an accounting principle promulgated by the body designated by the AICPA Council to establish such principles.
e. Accounting principles have not been applied consistently.

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[3] As to circumstances in which the auditor is not independent, see section 504. [Reference changed by the issuance of Statement on Auditing Standards No. 26, *Association with Financial Statements.*]

f. The financial statements are affected by uncertainties concerning future events, the outcome of which is not susceptible of reasonable estimation at the date of the auditor's report.

g. The auditor wishes to emphasize a matter regarding the financial statements.

Scope Limitation

.10 The auditor can determine that he is able to express an unqualified opinion only if his examination has been conducted in accordance with generally accepted auditing standards and if he therefore has been able to apply all the procedures he considers necessary in the circumstances. Restrictions on the scope of his examination, whether imposed by the client or by circumstances such as the timing of his work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, may require him to qualify his opinion or to disclaim an opinion. In such instances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report.

.11 The auditor's decision to qualify his opinion or disclaim an opinion because of a scope limitation depends on his assessment of the importance of the omitted procedure(s) to his ability to form an opinion on the financial statements examined. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to the financial statements. If the potential effects relate to many financial statement items, this significance is likely to be greater than if only a limited number of items is involved.

.12 Common restrictions on the scope of the auditor's examination include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors,[4] but restrictions may concern other phases of the audit (for example, see section 542.06). Restrictions on the application of these or other audit procedures to important elements of the

[4] Circumstances such as the timing of his work may make it impracticable or impossible for the auditor to accomplish these procedures. In such case, if he is able to satisfy himself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of his work, and his report need not include reference to the omission of the procedures or to the use of alternative procedures.

financial statements require the auditor to decide whether he has examined sufficient competent evidential matter to permit him to express an unqualified or qualified opinion, or whether he should disclaim an opinion. When restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on the financial statements.

.13 The auditor may be asked to report on one basic financial statement and not on the others. For example, he may be asked to report on the balance sheet and not on the statements of income, retained earnings or changes in financial position. These engagements do not involve scope limitations if the auditor's access to information underlying the basic financial statements is not limited and if he applies all the procedures he considers necessary in the circumstances; rather, such engagements involve limited reporting objectives.

Opinion Based in Part on Report of Another Auditor

.14 When the auditor decides to make reference to the report of another auditor as a basis, in part, for his opinion, he should disclose this fact in stating the scope of his examination and should refer to the report of the other auditor in expressing his opinion. These references indicate division of responsibility for performance of the examination. Although they are departures from the standard report language, they do not constitute a qualification of the auditor's opinion. (See section 543.)

Departure From a Generally Accepted Accounting Principle

.15 *General.* When financial statements are materially affected by a departure from generally accepted accounting principles and the auditor has examined the statements in accordance with generally accepted auditing standards, he should express a qualified or an adverse opinion (see paragraphs .29 and .41). The basis for such opinion should be stated in his report.

.16 In deciding whether the effects of a departure from generally accepted accounting principles are sufficiently material to require either a qualified or an adverse opinion, one factor to be considered is the dollar magnitude of the effects. However, materiality does not depend entirely on relative size: the concept involves qualitative as well as quantitative judgments. The significance of an item to a particular enterprise (e.g., inventories to a manufacturing company), the pervasiveness of the misstatement (e.g., whether it affects the amounts and presentation of numerous financial statement items), and the impact of the misstatement on the financial statements taken as a whole are all factors to be considered in making a judgment regarding materiality.

.17 *Inadequate disclosure.* Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements. If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should express a qualified or an adverse opinion because of the departure from those principles and should provide the information in his report, if practicable, unless its omission from the auditor's report is recognized as appropriate by a specific Statement on Auditing Standards. (See section 431* regarding the adequacy of informative disclosure, and section 545.04—.05 regarding the omission of a statement of changes in financial position.) [As amended December, 1977 by Statement on Auditing Standards No. 21.] (See section 435.)

Departure From a Promulgated Accounting Principle

.18 Rule 203 [ET section 203.01] of the AICPA Code of Professional Ethics [5] states:

> A member shall not express an opinion that financial statements are presented in conformity with generally accepted accounting principles if such statements contain any departure from an accounting principle promulgated by the body designated by Council to establish such principles which has a material effect on the statements taken as a whole, unless the member can demonstrate that due to unusual circumstances the financial statements would otherwise have been misleading. In such cases his report must describe the departure, the approximate effects thereof, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

.19 When the circumstances contemplated by Rule 203 [ET section 203.01] are present, the auditor's report should include, in a separate paragraph or paragraphs, the information required by the rule. In such a case, it is appropriate for him then

* Reference changed by issuance of Statement on Auditing Standards No. 32.

[5] This rule supersedes the Special Bulletin of the Council of the AICPA, issued in October 1964 and referred to in the text of sections 545.04 and 546.12. [As amended July, 1975, by Statement on Auditing Standards No. 5.] (See section 411.)

to express an unqualified opinion with respect to the conformity of the financial statements with generally accepted accounting principles unless there are other reasons, not associated with the departure from a promulgated principle, to modify his report.

Accounting Principles Not Consistently Applied

.20 When there has been a change in accounting principles, the auditor should modify his opinion as to consistency. Section 546, discusses variations in report language that are appropriate when accounting principles have not been applied consistently.

Uncertainties

.21 In preparing financial statements, management is expected to use its estimates of the outcome of future events. Estimates customarily are made in connection with matters such as the useful lives of depreciable assets, the collectibility of accounts receivable, the realizable value of inventory items, and the amount of a liability for product warranty. In most cases, the auditor is able to satisfy himself regarding the reasonableness of management's estimates by considering various types of audit evidence, including the historical experience of the entity, and the relevance of the evidence in estimating the effects of future events. Matters are not to be regarded as uncertainties for purposes of this section unless their outcome is not susceptible of reasonable estimation, as discussed in paragraph .22. If the auditor, on the basis of evidence available to him, disagrees with management's determination, and if the effects on the financial statements are material, he should express a qualified or an adverse opinion because of a departure from generally accepted accounting principles.

.22 In certain instances, the outcome of matters that may affect the financial statements or the disclosures required therein is not susceptible of reasonable estimation; such matters are to be regarded as uncertainties for purposes of this section. When such uncertainties exist, it cannot be determined whether the financial statements should be adjusted, or in what amount.

.23 There may be uncertainties with respect to specific matters whose possible effects on the financial statements can be isolated and therefore readily understood. Examples are the recoverability of a deferred cost or the likelihood that a material amount will become collectible or payable because of income tax adjustments or litigation. Also, there may be multiple uncertainties or uncertainties whose possible effects are complex and whose impact on the financial statements consequently is difficult for a reader to assess. Examples of conditions indicating the existence of uncertainties of the latter kind are recurring operating losses, serious deficiencies in working capital, an inability to obtain financing sufficient for continued business operations, and failure to comply with the terms of loan agreements. In some situations an adverse outcome of matters in either category could imperil the continued existence of the entity.[6] In any event, if the effects of the matters on the financial statements could be material, their nature and their possible effects should be disclosed in the statements.

.24 Evidence as to the resolution of an uncertainty cannot be expected to exist at the time of the auditor's examination because the resolution, and therefore the evidence, is prospective. The auditor's function in forming an opinion on financial statements does not include estimating the outcome of future events if management is unable to do so. When there are material uncertainties, the outcome of which is not susceptible of reasonable estimation, the auditor should consider whether to express an unqualified opinion or to qualify his opinion as discussed in paragraph.25.[7] The auditor need not modify his opinion because of the existence of an uncertainty when he concludes that there is only a minimal likelihood that resolution of the uncertainty will have a material effect on the financial statements.

.25 In cases involving uncertainties, the auditor should be able to form an opinion whether the financial statement items affected have been stated in conformity with generally accepted accounting principles in all respects other than those contingent on the outcome of the uncertainties. If he is satisfied that they have been so stated, he may appropriately express an opinion qualified by reason of the uncertainties (see paragraphs.35 and.39).[8] If the auditor believes that

[6] In such circumstances, the auditor is concerned with the recoverability and classification of recorded asset amounts and with the amounts and classification of liabilities. [Editor's Note: See section 340.]

[7] **The auditor may disclaim an opinion as discussed in footnote 8.**

[8] The Committee believes that the explanation of the uncertainties and the qualification of the auditor's opinion contemplated by this section should serve adequately to inform the users of the financial statements. Nothing in this section, however, is intended to preclude an auditor from declining to express an

the financial statement items affected by uncertainties reflect the application of accounting principles that are not generally accepted, he also should modify his report to state his reservations regarding departures from generally accepted accounting principles.

.26 The subsequent resolution of an uncertainty that has led to a modification of the auditor's opinion will (a) result in adjustment of the financial statements as to which his report originally was modified, (b) be recognized in the financial statements of a subsequent period, or (c) result in a conclusion that the matter has no monetary effect on the financial statements of any period. The qualifying expression in the opinion paragraph of the auditor's report should be the same regardless of the accounting treatment that is expected to be accorded the resolution of the uncertainty.

Emphasis of a Matter

.27 In some circumstances, the auditor may wish to emphasize a matter regarding the financial statements, but nevertheless intends to express an unqualified opinion. For example, he may wish to point out that the entity is a component of a larger business enterprise or that it has had significant transactions with related parties,* or he may wish to call attention to an unusually important subsequent event or to an accounting matter affecting the comparability of the financial statements with those of the preceding period. Such explanatory information may be presented in a separate paragraph of the auditor's report. Phrases such as "with the foregoing explanation" should not be used in the opinion paragraph in situations of this type.

Unqualified Opinion

.28 An unqualified opinion states that the financial statements present fairly financial position, results of operations and changes in financial position in conformity with generally accepted accounting principles (which include adequate disclosure) consistently applied (see paragraph .07). This conclusion may be expressed only

opinion in cases involving uncertainties. If he disclaims an opinion, the uncertainties and their possible effects on the financial statements should be disclosed in an appropriate manner (see paragraph .23), and the auditor's report should give all the substantive reasons for his disclaimer of opinion (see paragraph .45).

* [Editor's Note: See section 335.]

when the auditor has formed such an opinion on the basis of an examination made in accordance with generally accepted auditing standards.

Qualified Opinion

General

.29 A qualified opinion states that, "except for" or "subject to" the effects of the matter to which the qualification relates, the financial statements present fairly financial position, results of operations and changes in financial position in conformity with generally accepted accounting principles consistently applied. Such an opinion is expressed when a lack of sufficient competent evidential matter or restrictions on the scope of the auditor's examination have led him to conclude that he cannot express an unqualified opinion, or when the auditor believes, on the basis of his examination, that

a. the financial statements contain a departure from generally accepted accounting principles, the effect of which is material,
b. there has been a material change between periods in accounting principles or in the method of their application, or
c. there are significant uncertainties affecting the financial statements,

and he has decided not to express an adverse opinion or to disclaim an opinion.

.30 Ordinarily the auditor should not modify the language of the opinion paragraph of the standard report unless he is qualifying his opinion. However, reference to another auditor's report as a basis, in part, of the principal auditor's opinion is not considered to be a qualification (see paragraph.14).

.31 Financial statements, including the accompanying notes, sometimes contain unaudited information, pro forma calculations or other similar disclosures. These disclosures may be required in connection with a particular transaction (e.g., a business combination) or may otherwise be considered informative (e.g., in connection with subsequent events). If such disclosures are appropriately identified as "unaudited" or as "not covered by auditor's report," the auditor need not refer to them in his report. The reporting criteria stated in sections 504 * and 711.13 * * apply to such data. If the unaudited

* Reference changed by the issuance of Statement on Auditing Standards No. 26, *Association with Financial Statements.*

** Reference changed by issuance of Statement on Auditing Standards No. 37.

information (e. g., an investor's share, material in amount, of an investee's earnings recognized on the equity method) is such that it should be subjected to auditing procedures in order for the auditor to form an opinion with respect to the financial statements taken as a whole, and the auditor has not been able to apply the procedures he considers necessary, he should qualify his opinion or disclaim an opinion because of a limitation on the scope of his examination.

Report Form

.32 When the auditor intends to express a qualified opinion, he should disclose all the substantive reasons in a separate explanatory paragraph(s) of his report, and should include, in the opinion paragraph, the appropriate qualifying language and a reference to the explanatory paragraph(s). The requirement for an explanatory paragraph does not apply when the opinion paragraph has been modified because of a change in accounting principle (see paragraph .20).

.33 The explanatory paragraph(s) should disclose the principal effects of the subject matter of the qualification on financial position, results of operations and changes in financial position, if reasonably determinable. If the effects are not reasonably determinable, the report should so state. If such disclosures are made in a note to the financial statements, the explanatory paragraph(s) may be shortened by referring to it. The explanatory paragraph(s) also should make clear whether the matter is (a) one as to which there is a difference of opinion between the auditor and his client and for which the auditor believes an adjustment should be made or (b) one involving an uncertainty that cannot presently be resolved because the outcome depends on future events. If an auditor wishes to emphasize a matter or disclosure regarding the financial statements but does not intend to qualify his opinion (see paragraph .27), he should not refer to this information in the opinion paragraph of his report.

.34 When a qualified opinion results from a limitation on the scope of the examination or an insufficiency of evidential matter, the situation should be described in the explanatory paragraph and referred to in both the scope and opinion paragraphs of the auditor's report. It is not appropriate for the auditor to request that the scope of his examination be explained in a note to the financial statements, inasmuch as the description of the scope is the auditor's representation and not that of his client.

Qualifying Language

.35 A qualified opinion should include the word "except" or "exception" in a phrase such as "except for" or "with the exception of" unless the qualification arises because of an uncertainty affecting the financial statements; then the expression "subject to" should be used. Phrases such as "with the foregoing explanation" are not clear or forceful enough and should not be used. Since accompanying notes are deemed to be part of the financial statements, wording such as "fairly presented when read in conjunction with Note 1" is likely to be misunderstood and likewise should not be used.

.36 An example of a report in which the opinion is qualified because of the use of an accounting principle at variance with generally accepted accounting principles follows (assuming the effects are such that the auditor has concluded an adverse opinion is not appropriate):

(Separate paragraph)

The Company has excluded from property and debt in the accompanying balance sheet certain lease obligations, which, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by $......, long-term debt by $......, and retained earnings by $......as of December 31, 19XX, and net income and earnings per share would be increased (decreased) by $...... and $...... respectively for the year then ended.

(Opinion paragraph)

In our opinion, except for the effects of not capitalizing lease obligations, as discussed in the preceding paragraph, the financial statements present fairly. . . .

.37 If the pertinent facts are disclosed in a note to the financial statements, a separate paragraph of the auditor's report in the circumstances illustrated in paragraph .36 might read as follows:

(Separate paragraph)

As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accompanying balance sheet. In our opinion, generally accepted accounting principles require that such obligations be included in the balance sheet.

.38 If a qualification arises because of lack of consistency in the application of accounting principles, the qualifying language should be positioned in the opinion paragraph so as to make this clear. (See section 546.)

.39 An example of a report qualified because of an uncertainty affecting the financial statements follows:

(Separate paragraph)

As discussed in Note X to the financial statements, the Company is defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. Company officers and counsel believe the Company has a good chance of prevailing, but the ultimate outcome of the lawsuits cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.

(Opinion paragraph)

In our opinion, subject to the effects, if any, on the financial statements of the ultimate resolution of the matter discussed in the preceding paragraph, the financial statements referred to above present fairly. . . .

or

In our opinion, subject to the effects of such adjustments, if any, as might have been required had the outcome of the uncertainty referred to in the preceding paragraph been known, the financial statements referred to above present fairly. . . .

.40 When an auditor qualifies his opinion because of a scope limitation, the wording in the opinion paragraph should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself. An example regarding inventories (assuming the effects of the limitation are not such that the auditor has concluded a disclaimer of opinion is appropriate — see paragraph .11) follows:

(Scope paragraph)

Except as explained in the following paragraph, our examination . . . and such other auditing procedures as we considered necessary in the circumstances. . . .

(Separate paragraph)

We did not observe the taking of the physical inventories as of December 31, 19XX (stated at $. . . . . .), and December 31, 19X1 (stated at $. . . . . .), since those dates were prior to the time we were initially engaged as auditors for the Company. Due to the nature of the Company's records, we were unable to satisfy ourselves as to the inventory quantities by means of other auditing procedures.[9]

(Opinion paragraph)

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to observe the physical inventories. . . .

Wording such as "In our opinion, except for the above-mentioned limitation on the scope of our examination . . ." bases the exception on the restriction itself, rather than on the possible effects on the financial statements, and therefore is unacceptable.

Adverse Opinion

.41 An adverse opinion states that financial statements do not present fairly the financial position, results of operations or changes in financial position in conformity with generally accepted accounting principles. Such an opinion is expressed when, in the auditor's judgment (see paragraph .16), the financial statements taken as a whole are not presented fairly in conformity with generally accepted accounting principles.

.42 When the auditor expresses an adverse opinion, he should disclose in a separate paragraph(s) of his report (a) all the substantive reasons for his adverse opinion and (b) the principal effects of the subject matter of the adverse opinion on financial position, results of operations and changes in financial position, if reasonably determinable. If the effects are not reasonably determinable, the report should so state. The report also should state any reservations the auditor has regarding fair presentation in conformity with generally accepted accounting principles other than those giving rise to the adverse opinion.

.43 When an adverse opinion is expressed, the opinion paragraph should include a direct reference to a separate paragraph that discloses the basis for the adverse opinion.

[9] If the auditor has been unable also to carry out other tests, such as those relating to the pricing and clerical accuracy of the inventories, the language in the separate and opinion paragraphs should be modified accordingly.

(Separate paragraph)

As discussed in Note X to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Generally accepted accounting principles, in our opinion, require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided. Because of the departures from generally accepted accounting principles identified above, as of December 31, 19XX, inventories have been increased \$...... by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is carried at \$...... in excess of an amount based on the cost to the Company; and allocated income tax of \$...... has not been recorded; resulting in an increase of \$...... in retained earnings and in appraisal surplus of \$....... For the year ended December 31, 19XX, cost of goods sold has been increased \$...... because of the effects of the depreciation accounting referred to above and deferred income taxes of \$...... have not been provided, resulting in an increase in net income and earnings per share of \$...... and \$...... respectively.

(Opinion paragraph)

In our opinion, because of the effects of the matters discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of X Company as of December 31, 19XX, or the results of its operations and changes in its financial position for the year then ended.

.44 Because an opinion as to consistency implies the application of generally accepted accounting principles, no reference to consistency should be made in the opinion paragraph when an adverse opinion is issued. However, if the auditor has specific exceptions as to consistency, these exceptions should be expressed in the report.

Disclaimer of Opinion

.45 A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. When the auditor disclaims an opinion, he should state in a separate paragraph(s) of his report all of his substantive reasons for doing so, and also should disclose any other reservations he has regarding fair presentation in conformity with generally accepted accounting principles or the consistency of their application. The disclaimer of opinion is appropriate when the auditor has not performed an examination sufficient in scope to enable him to form an opinion on the financial statements (see paragraphs .10, .11, and .12).[10] A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his examination, that there are material departures from generally accepted accounting principles (see paragraphs .15, .16, and .17).

.46 When expressing a disclaimer because of a significant scope limitation, the auditor should indicate in a separate paragraph(s) the respects in which his examination did not comply with generally accepted auditing standards. He should state that the scope of his examination was not sufficient to warrant the expression of an opinion. The auditor should not indicate the procedures performed; to do so may tend to overshadow the disclaimer.

.47 An example of a disclaimer resulting from an inability to obtain sufficient competent evidential matter follows:

(Scope paragraph)

... Except as set forth in the following paragraph, our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

(Separate paragraph)

The Company did not take a physical inventory of merchandise, stated at $...... in the accompanying financial statements as of December 31, 19XX, and at $...... as of December 31, 19X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19XX is no longer available. The Company's records do not permit the application of adequate alternative procedures regarding the inventories or the cost of property and equipment.

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[10] A disclaimer may be issued in cases involving uncertainties. See the footnote to paragraph .25. If an accountant is engaged to conduct an examination of the financial statements of a nonpublic entity in accordance with generally accepted auditing standards, but is requested to change the engagement to a review or compilation of the statements, he should look to the guidance in Statement on Standards for Accounting and Review Services 1, paragraphs 44—49 [AR section 100.44-.49]. [As amended, November 1979, by Statement on Auditing Standards No. 26.] (See section 504.)

(Disclaimer paragraph)

Since the Company did not take physical inventories and we were unable to apply adequate alternative procedures regarding inventories and the cost of property and equipment, as noted in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements referred to above.

Piecemeal Opinion

.48 Piecemeal opinions (expressions of opinion as to certain identified items in financial statements) sometimes have been issued heretofore when the auditor disclaimed an opinion or expressed an adverse opinion on the financial statements taken as a whole.[11] Because piecemeal opinions tend to overshadow or contradict a disclaimer of opinion or an adverse opinion,[12] they are inappropriate and should not be issued in any situation.

Reports on Comparative Statements

[.49] [Superseded by Statement on Auditing Standards No. 15, effective for periods ending after June 30, 1977.] (See section 505.)

Effective Date

.50 Statements on Auditing Standards generally are effective at the time of their issuance. However, since the provisions of this section change certain reporting practices heretofore considered acceptable, this section will be effective with respect to reports issued on financial statements for periods ending on or

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[11] The use of a piecemeal opinion following a disclaimer of opinion has not been permitted when the disclaimer was occasioned by a significant client-imposed restriction on audit scope.

[12] In view of the provisions of this paragraph, the last sentence of section 544.02, having to do with companies whose accounting practices are prescribed by governmental regulatory authorities or commissions, is amended to read as follows:

> An adverse opinion may be accompanied by an opinion on supplementary data which are presented in conformity with generally accepted accounting principles.

[13] [Superseded by Statement on Auditing Standards No. 15, effective for periods ending after June 30, 1977.] (See section 505.)

after December 31, 1974, and need not be applied retroactively. The Committee understands that arrangements already may have been made for certain engagements, at the conclusion of which the auditor customarily has expressed a piecemeal opinion following a disclaimer of opinion occasioned by scope limitations. In order to provide a period of orderly transition, since the use of piecemeal opinions will no longer be appropriate under the provisions of paragraph .48 of this section, the provisions of that paragraph will be effective with respect to reports issued on financial statements for periods ending on or after January 31, 1975.

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3. Reporting on Loss Contingencies

.11 *Question*—Statement on Financial Accounting Standards No. 5,* "Accounting for Contingencies," of the Financial Accounting Standards Board specifies criteria for accruing and disclosing loss contingencies. What is the relationship between the criteria established in Statement No. 5 [AC section 4311] and the auditor's reporting obligations when the financial statements on which he is reporting are affected by such uncertainties?

.12 *Interpretation*—In discussing loss contingencies Statement No. 5 [AC section 4311] uses the terms ***probable, reasonably possible*** and ***remote*** to describe different degrees of likelihood that future events will confirm a loss or an impairment of an asset or incurrence of a liability and the accounting standards for accrual and disclosure are based on those terms. Paragraph 3 of that Statement defines those terms as follows:

Probable. The future event or events are likely to occur.

Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.

Remote. The chance of the future event or events occurring is slight.

.13 Section 509.22 states: "In certain instances, the outcome of matters that may affect the financial statements or the disclosures required therein is not susceptible of reasonable estimation; such matters are to be regarded as uncertainties. . . ." Section 509.24 states: "The auditor need not modify his opinion because of the existence of an uncertainty when he concludes that there is only a minimal likelihood that resolution of the uncertainty will have a material effect on the financial statements." The meaning of "minimal likelihood" as used in section 509 is equivalent to "remote" as used in FASB Statement No. 5.* Consequently, an independent auditor need not modify his opinion because of the existence of an uncertainty when he concludes that there is only a remote likelihood that resolution of the uncertainty will have a material effect on the financial statements on which he is reporting.

.14 When a future event or events that will resolve an existing contingency are reasonably possible (chance of occurrence is more than remote but less than likely) and the amount of the potential liability cannot be estimated, the auditor might modify his opinion if he concludes the potential effect of the resolution of the uncertainty is material. When the events that will resolve a contingency are probable (likely to occur), but the amount of the loss cannot be estimated, an uncertainty exists. In this case, the auditor should modify his opinion when he believes that the resolution of the uncertainty will have material effect on the financial statements he is examining.

[Issue Date: January, 1976.]

6. The Materiality of Uncertainties

.25 *Question*—Section 509.24 states that "When there are material uncertainties, the outcome of which is not susceptible of reasonable estimation, the auditor should consider whether to express an unqualified opinion or to qualify his opinion. . . ." What approach should the auditor use in considering whether the potential effect of an uncertainty is material?

.26 *Interpretation*—Materiality is a relative concept and the basis of comparison is thus an important aspect of the auditor's consideration of whether an uncertainty is material. Some uncertainties relate primarily to financial position while others more closely relate to results of operations. Thus the auditor should consider the potential effect on the financial statement that is most appropriate in the circumstances.

.27 Some uncertainties are unusual in nature or infrequent in occurrence and thus more closely related to financial position than to normal, recurring operations. Examples include the recoverability of start-up costs and litigation relating to alleged violations of antitrust or securities laws. In such instances the auditor should evaluate the materiality of the uncertainty by comparing the potential effect to shareholders' equity and also to other relevant balance sheet components such as total assets, total liabilities, current assets or current liabilities.

.28 In other instances the nature of an uncertainty may be more closely related to normal, recurring operations, for example, litigation with a party to a royalty agreement concerning whether a royalty fee should be paid on certain revenues, and revenues of certain public utilities collected subject to refund. In such circumstances it is appropriate to consider the materiality of the uncertainty in relation to the potential effect on the income statement.

[Issue Date: October, 1979.]

7. Reporting on an Uncertainty

.29 *Question*—Section 509.39 on "Reports on Audited Financial Statements" gives two examples of an opinion that is qualified because of an uncertainty. In light of FASB Statement No. 16 [AC section 2014] which virtually eliminates prior period adjustments, is it equally acceptable to word a qualified opinion "subject to the effects, if any" either "on the financial statements of the ultimate resolution of the matter . . ." or "of such adjustments as might have been required had the outcome of the uncertainty been known . . ."?

.30 *Interpretation*—No. The language in the first example, which refers to the effects, if any, on the financial statements of the ultimate resolution, ordinarily should no longer be used. It implies that the financial statements being reported on may be adjusted when the uncertainty is resolved. Since FASB Statement No. 16 [AC section 2014] has eliminated prior period adjustments for all but a few items that are typically unrelated to uncertainties, the resolution of an uncertainty will either be recognized in the financial statement of a later period or have no monetary effect.

.31 The language in the second example, which refers to adjustments that might have been required, normally is preferable. It makes clear that the qualification relates to a matter that would have a material effect on the financial statements if resolved unfavorably in the current period without the implication that the statements could be adjusted in the future.

.32 The language in the first example is appropriate in the rare instances when the resolution of an uncertainty will be accounted for as a prior period adjustment, such as an uncertainty related to utility revenue under rate-making processes for certain regulated companies.

[Issue Date: October, 1979.]